COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JULY 11, 2000

APPLICATION OF

THE POTOMAC EDISON COMPANY
d/b/a ALLEGHENY POWER CASE NO. PUE000280

ORDER APPROVING PHASE I TRANSFERS

On May 25, 2000, The Potomac Edison Company, d/b/a Allegheny Power ("AP" or "Company") filed an application, pursuant to §§ 56-77, 56-90, 56-88.1 (to the extent this provision is applicable), and 56-590 B of the Code of Virginia, for approval of a plan (the "Plan") for the functional separation of its generating assets from its transmission and distribution assets, as required by the Virginia Electric Utility Restructuring Act (the "Act").

In the application, AP proposed to separate its generation facilities from its transmission and distribution facilities by transferring its generating assets, certain utility securities, and certain contractual entitlements to generation to an affiliate called "GENCO," which would operate the generation facilities. AP would continue to own its transmission and distribution plant in Virginia and proposed to continue to read meters and bill customers as an energy delivery company.

In Phase I of the Plan, AP requested Commission approval, effective July 1, 2000, of the transfer to GENCO of all of its undivided interests in its generating facilities, with the exception of certain hydroelectric facilities in Virginia having an aggregate of less than 5 MW of capacity. As an additional part of Phase I, AP requested approval of its transfer to GENCO of all its shares of the stock of Allegheny Generating Company, which holds 40% interest in the Bath County Pump Storage Project, located in Bath County, Virginia. The requested transfers are to be made at book value.

AP also requests approval to transfer to GENCO as part of Phase I of the Plan, rights and responsibilities it has in an inter-company power agreement, dated July 10, 1953, with the Ohio Valley Electric Cooperative ("OVEC"). Under this agreement, AP can sell power to and, at times, purchase power from OVEC. Final transfer of its interests in the OVEC contract will require further action of the Federal Energy Regulatory Commission ("FERC"), but AP has requested approval of the Phase I transfer of its rights and responsibilities in this proceeding.

Finally, AP seeks approval to transfer to GENCO its rights and responsibilities under the agreements to which it is now party for the operation of the generating plants it seeks to transfer, and interim approval to transfer to GENCO certain

"incidental interconnection, access and easement" agreements between it and other affiliates necessary to enable GENCO to operate the generating plants. If there are any such agreements, AP will further identify them and seek final approval of any transfer in a Phase II proceeding to be filed at a later date.

In its application, AP filed a Memorandum of Understanding ("MOU") it reached with the Commission's Staff ("Staff"). The MOU contains certain representations and undertakings that AP has made in order to comply with the requirements of the Act. The Company agreed to make a base rate reduction to its Virginia customers of $1 million annually, effective July 1, 2000, with the reduction applied ratably to each rate classification. Further, AP agreed not to file an application for a base rate increase prior to January 1, 2001. AP agreed to operate and maintain its distribution system in Virginia at or above historic levels of service quality and reliability, and to implement timely distribution system improvements needed to maintain the quality of its service. During periods when AP will provide default service as provided by the Act, it will contract for generation services for default service customers at the same cost that it would incur to serve customers from the units it now owns, but now seeks to divest to GENCO under the Plan.

The final aspect of the MOU involved modification to the manner in which the Company recovers its fuel costs. AP proposed to terminate its fuel factor cost recovery mechanism beginning July 1, 2000, and instead recover fuel costs in base rates. The Company and Staff agreed in the MOU that costs now recovered through the Company's current fuel factor would be rolled into the base rates at an effective rate of 1.181 cents/kWh which reflects an increase to the current fuel factor. After July 1, 2000, the Company agreed to forego any fuel cost adjustments that would otherwise be permitted under the Act.

On June 9, 2000, we issued our Order for Notice and Comment, establishing a procedural schedule in which we separated our consideration of the proposed Phase I transfers from our consideration of the cost issues associated with the proposed elimination of the fuel factor. Section 56-249.6 of the Code of Virginia ("Code") provides that the Commission may dispense with the fuel cost recovery mechanism only "after notice and hearing" and finding that the electric utility's fuel costs "can be reasonably recovered through the rates and charges" established in accordance with other provisions of law. Accordingly, we have established a public hearing to receive evidence and argument on this aspect of the Plan, which will be convened on July 20, 2000.

With respect to the proposed asset transfers, our June 9 Order directed interested parties to file comments or request hearing on or before June 30, 2000. Persons interested in participating in the proceedings as Protestant were obligated to file their notices of protest on or before June 27, 2000. Only Virginia Electric and Power Company ("Virginia Power") filed a notice, and it clearly stated that it did not object to the Commission giving expedited consideration to the proposed Phase I transfers. Virginia Power did not request a hearing, but advised of its desire to participate if any hearing was ordered.

Virginia Power's notice of protest registers that company's opinion that certain aspects of the MOU "are not required by, and in certain respects are contrary to the intent of, the Restructuring Act." Thus, Virginia Power seeks to ensure that our consideration of AP's application and particularly the MOU does not establish any precedent by which Virginia Power's eventual filing will be adjudged.

The Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"), in a letter dated June 27, 2000, advised the Commission that it intended to participate in the proceeding. Consumer Counsel did not request hearing. On June 30, 2000, Consumer Counsel filed comments stating that it did not oppose expedited consideration of the proposed transfers

and that "Consumer Counsel supports the Staff's effort to reach a memorandum of understanding with AP in this matter." The comments also contained a Stipulation negotiated between AP and Consumer Counsel in which the Company advised the Commission that it "will recover stranded generation costs as referenced in Section 56-584 of the Virginia Electric Utility Restructuring Act ("the Act") solely through capped rates as referenced in Section 56-582 of the Act, and will not assess a wires charge as referenced in Section 56-583 of the Act." Consumer Counsel's comments urged the Commission to condition the proposed transfers upon adoption of the stipulated agreement. The Comments also requested the Commission clarify Paragraph No. 4 of the MOU, which states that following the capped rate period prices for generation services to default customers "will be based on the then current generation costs of the existing system dedicated to serve retail Virginia load." Consumer Counsel urges that we interpret "existing system" to mean the now-existing generating system, rather than the system that will exist at the end of the capped rate period. Consumer Counsel believes the Company should be required to state at the July 20 hearing why any increase in its fuel factor is needed.

On June 29, 2000, the Staff filed a Report that addressed both the Phase I transfers and the rate implications of the elimination of the fuel factor. The Staff concluded that we

should approve the requested transfers, stating that "AP has met the legal requirements of § 56-590 through its commitment to contract for sufficient capacity and energy for its Virginia retail customers throughout the default service period[.]" Staff referenced "extensive negotiations" between it and the Company that culminated in the MOU and asserted that the MOU "incorporates many concessions and safeguards to ensure that adequate and reliable service at just and reasonable rates will continue to be provided to Virginia retail customers." The report advises that AP's commitment to contract for generation sufficient to meet its default service obligation at the frozen unbundled generation rate is the core pledge of the MOU. In Staff's view, this commitment satisfies the requirement of § 56-590 B 3(i) of the Code of Virginia that an incumbent utility's generation assets or their equivalent remain available for service during the default service period. Staff further noted the benefits of the proposed $1 million base rate reduction and the elimination of the fuel factor, finding that these "will serve to stabilize Virginia retail rates, and will protect Virginia customers from increases in fuel prices throughout the capped rate period."

On July 7, 2000, the Staff and Company filed a Motion to Supplement the Memorandum of Understanding in order to add a term to address the consequences of any subsequent decision by

GENCO to transfer the units AP proposes here to transfer to GENCO, at a time when AP is obligated to provide default service in Virginia. The additional language comprises AP's pledge to, within 3 months of any announcement by GENCO to divest ownership of the units, submit sufficient information to allow us to determine the then-current production costs of any such unit, together with its pledge to work with the Staff to develop a mechanism to escalate those costs appropriately over time.

NOW THE COMMISSION, having considered the application and supporting material, including the MOU, the Staff report and the comments filed herein, as well as the applicable statutes and rules, is of the opinion and finds that the Phase I transfers requested herein are in the public interest and should be approved. We find that adequate service to the public at just and reasonable rates will not be impaired or jeopardized by granting the prayer of the petition, as required by § 56-90 of the Code of Virginia.

The Commission is further of the opinion and finds that the representations and undertakings set forth in the MOU, as supplemented, provide satisfactory assurance that the public interest will be protected and that the "incumbent electric utility's generation assets or their equivalent" will remain available for electric service during the default service period. The Company has agreed during the capped rate period to

price generation at its frozen unbundled generation rate. For the period in which it is obligated to provide default service following the expiration of the capped rate period, generation service rates will be based on the Company's then-current generation cost of the portion of that generating system that it makes use of to meet its default service load. Should GENCO divest itself of any of the units, the Company agrees that on-going generation rates will reflect costs from those units at the time of their divestiture, escalated if necessary to reflect current costs. We find that the MOU, as supplemented, satisfies Consumer Counsel's request for a clarification from us regarding Paragraph No. 4 of that agreement.

Therefore, we find that the Phase I transfers conform to the requirements of § 56-590. We find that we should retain jurisdiction over these matters for the purpose of consideration of further aspects of the Company's functional unbundling plan, and will issue a final order on that plan following additional proceedings to be scheduled by separate order. Additionally, we will consider the provisions of the MOU that relate to the proposed elimination of the fuel factor and the proposed base rate reduction concurrently during the hearing scheduled for July 20, 2000. The remaining provisions of the MOU are adopted and incorporated as part of the approvals herein granted, as is the Stipulation concluded between AP and Consumer Counsel.

Accordingly, IT IS ORDERED THAT:

(1) The Motion to Supplement the Memorandum Of Understanding is granted.

(2) The approvals sought by AP pursuant to the Affiliates Act, Chapter 4 of Title 56 of the Code of Virginia, and the Transfers Act, Chapter 5 of Title 56 of the Code of Virginia, are granted as requested in the application and as modified by the terms of the Memorandum of Understanding, as supplemented on July 7, 2000, and subject to the Stipulation entered into between AP and Consumer Counsel.

(3) This matter is continued for further proceedings and further orders of the Commission.